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SURVIVOR PURCHASE AGREEMENTS AND TAXES*

GEORGE J. LAIKIN**

Businessmen must plan for death as well as for life. This is particularly true if privately owned and closely held enterprises are to remain important factors in our economy.¹

Because of the failure to make lifetime arrangements for the disposition of a decedent's interests therein, businesses are frequently liquidated or sold at a loss in order to raise money to meet pressing death charges and taxes. Planning is, therefore, as important for the surviving business associates as for the decedent's family.

The approach to pre-probate business planning depends upon the nature of the business, the extent to which the decedent had an interest therein, whether the business interest constitutes a large or small part of his estate, and the amount of income available for the support of his family from sources other than the business involved. While not every business interest should be sold at death, the welfare of the surviving family often necessitates a sale. The function of the survivor purchase agreement is to provide the mechanics for such a sale. If a sale is not to take place at death, the decedent's family can, nevertheless, be protected by a variety of arrangements and safeguards.²

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¹ The public policy of our nation—as distinguished from actual practice—favors the continuation of the small and medium sized business. The anti-trust legislation is an example. The Rev. Act. of 1954, by limiting the transfer for value rule, by permitting entity buy outs, and by expressly permitting the accumulation of surplus up to \$60,000 is a further example. The "Small Business Tax Adjustment Bill of 1958," which became part of the "Technical Amendments Act of 1958," provides faster depreciation of used property, extensions of the right of corporations to elect to be taxed as partners, and installment payments of estate taxes over a period of years.

² Arrangements might be made for the widow or children to become active in the business or otherwise receive income therefrom. Various control and voting arrangements could be considered. However, if the widow remarries, problems may arise in negotiating business arrangements with the second husband. Moreover, it might be unfair to require the survivors to continue to pay even a portion of the profits to the decedent's family when the latter might contribute little to the operation of the business. From the family's point of view it may be doubted whether its source of income should be dependent upon the vagaries and uncertainties of business. See Fuller,

Sole Proprietorship

Of the several forms of business entities, the sole proprietorship is most vulnerable. At the death of a sole proprietor, the business becomes part of his estate and is under the control of the probate court.³ Usually, it will be sold or liquidated as rapidly as possible.⁴ The sole proprietor should, therefore, through appropriate provisions in his will, enable his executors to carry on the business until such time as an advantageous disposition can be made.

Few survivor purchase agreements for sole proprietorship are executed.⁵ Because the proprietor has difficulty in finding a successor. If he does find a suitable one, often a key employee, such individual is given an interest in the business during lifetime, and the sole proprietorship is converted into a partnership or corporation.

Partnership

The partnership has analogous problems. Under the Uniform Partnership Act, as well as under the common law, it is automatically dissolved upon the death of one of the partners, unless an express agreement to the contrary has been made. While death dissolves a partnership, it is not actually terminated until its affairs have been wound up.⁶ During this interim, it can undertake no new transactions or ventures. It may carry on only those transactions necessary to conclude its affairs. The surviving partners are regarded as trustees for the deceased partner's interest, and are responsible as such to the probate court.⁷ They are required to account for any profits made. The deceased partner's interests are not liable for losses incurred by the survivors as a result of transactions entered into after death.⁸

Corporation

Fundamentally, the problems of the closely held corporation are

Partnership Agreements for Continuation of an Enterprise After Death of a Partner, 50 YALE L. J. 202 (1940).

³ All assets of the decedent not otherwise exempt are treated as part of the deceased's estate and pass under the control of the executor or administrator. 21 AM. JUR., *Executors & Administrators* §§ 185 and 197 (1939).

⁴ Unless there is an express authority to do so, probate courts frown upon the operation of a business by an estate. *Hall vs. Meriden Trust & Safe Deposit Co.*, 103 Conn. 226, 130 Atl. 157 (1925); *In re Thurbers Estate*, 311 Ill. 211, 142 N.E. 493 (1924); *In re Burke's Estate*, 108 Cal. 163, 244 Pac. 340 (1926).

⁵ Generally, the sale of a sole proprietorship is not a unitary transaction permitting classification of the entire business as a capital asset. *Williams v. McGowan*, 152 F.2d 570 (2nd Cir. 1945). Problems arise as to whether payments for inventory stock in trade, accounts receivable, covenants not to compete, good will, and similar items will be subject to ordinary income or capital gain treatment. Furthermore, problems may arise as to the allocation of the purchase price among the various individuals items acquired.

⁶ UNIFORM PARTNERSHIP ACT, §§ 29, 30, and 31.

⁷ UNIFORM PARTNERSHIP ACT, § 21; *Losch v. Marcin*, 251 N.Y. 402, 167 N.E. 514 (1929); *Fleming v. Fleming*, 211 Iowa 1251, 230 N.W. 359 (1930); *Vasiljevich v. Radanovich*, 138 Cal. App. 97, 31 P. 2d 802 (1934); *Moffet v. Pierce*, 344 Pa. 16, 24 A.2d 448 (1942).

⁸ UNIFORM PARTNERSHIP ACT, § 34.

the same as those of the partnership, except of course that the corporation does not terminate upon death. The relationship between the stockholders, the continuity of the business, and the protection of the decedent's family involve the same consideration.

Elements of Agreement

There are two basic approaches to the purchase of the interests of a deceased partner or stockholder. Under one, the cross-purchase, the surviving partners or stockholders make the purchase. Under the other, the purchase is by the entity—by the partnership or the corporation itself. The determination of which course to follow will depend on both business and tax considerations.

Pattern of Agreement

The parties to and the provisions of the agreement necessarily depend upon whether the business is a partnership or a corporation, and whether the buy out is to be by the survivors or by the entity. In any event, the instrument should be a binding contract. An instrument embodying only mutual options is not effective.⁹ If the agreement is in the form of an option, it should be based on sufficient consideration so that if the optionor elects to sell, the optionee is obligated to purchase.¹⁰ A price, or a method of determining it, should be spelled out with certainty. The method of payment should be set forth.

Wherever possible, the agreement should be funded by life insurance. Because of recent tax confusion there is disagreement as to whether the insurance should be referred to in the agreement. But, it would appear that sufficient clarification of the tax problems has already taken place to minimize the danger of such reference.

If services of a trustee or escrow holder are used, provisions relating thereto should be included, as should provisions relating to the restraint on the sale or disposition of the shares or business interest. Mechanics for the settlement of disputes, for certifying the figures reflected by the books, methods of dealing with problems of the corporation not having sufficient surplus at the time to buy out, the creation of a sinking fund if needed, and the time within which various steps should be taken, must be covered.

The agreement may also deal with such problems as voting rights, voting in concert, control and management, both during lifetime and after death. Sometimes wives are made parties although they have no direct interest in the business. There appears to be no legal necessity for this, except possibly in community property states.¹¹ Practi-

⁹ *Comm. v. Bense*, 100 F.2d 639 (3rd Cir. 1938); *Armstrong's Estate v. Comm.*, 146 F.2d 457 (7th Cir. 1945); *Cowles v. State of Washington*, 219 P. 2d 964 (Wash. 1950).

¹⁰ *PAGE, CONTRACTS* § 582 (1919); 12 *AM. JUR., CONTRACTS* § 15 (1938); *Miskowitz v. Starobin*, 41 N.Y.S. 2d 786, 267 App. Div. 866 (1943).

¹¹ Generally, in community property states a wife's signature is essential if, in

cally, however, making the wife a party may have the effect of placing her on notice and reducing her resistance to the implementation of the agreement if the results are not satisfactory to her.¹²

Enforceability

Agreements providing for the sale of a business interest at death have generally been upheld by the courts.¹³ They are usually not regarded as testamentary in nature,¹⁴ and are considered to be binding upon the personal representatives and heirs of the decedent.¹⁵

Enforceability problems have arisen under a variety of factual situations.¹⁶ Some relate to the adequacy of price; to ambiguity in the method of arriving at a price; to the right of the corporation to acquire the shares in view of the absence of surplus; to the absence of good faith; to the

the business purchase, she will receive less than one-half of an adequate purchase price. 2 R & R Advanced Underwriting Service, 15-37 (e).

¹² Similarly, there is no legal necessity for referring to these agreements in the wills of the parties. Nevertheless, wills do frequently direct the executors to carry out the provisions of such agreements. Again, the effect is not a legal one, but a practical one of giving all parties, including the decedent's family, further notice of his intentions.

¹³ *Casey v. Hurley*, 112 Conn. 526, 152 Atl. 892 (1931); *Rankin v. Newman*, 114 Cal. 635, 46 Pac. 742 (1896); *Kavanaugh v. Johnson*, 290 Mass. 587, 195 N.E. 797 (1935); *In re Rohrbacher's Estate*, 168 Pa. 158, 32 Atl. 30 (1895) (*reversing* 14 Pa. Co. Ct. 568, 3 Pa. Dist. R. 264 (1894)); *In re Eddy's Estate*, 175 Misc. 1011, 26 N.Y.S. 2d 115 (1941); See also 40 AM. JUR., *Partnerships* § 311 (1942); *Notes and Cases* at 73 A.L.R. 983 (1931); *Forster, Legal, Tax and Practical Problems Under Partnership Purchase and Sale Agreement*, 19 So. CAL. L. REV. 1 (1945).

¹⁴ *Murphy v. Murphy*, 217 Mass. 233, 104 N.E. 466 (1914); *In re Fieux's Estate*, 241 N.Y. 277, 149 N.E. 857 (1925); *McKinnon v. McKinnon*, 56 Fed. 409 (8th Cir. 1893).

¹⁵ *Lockwoods Trustee v. Lockwood*, 250 Ky. 262, 62 S.W. 2d 1053 (1933); *Kavanaugh v. Johnson*, 290 Mass. 587, 193 N.E. 797 (1935). This is true whether or not the purchase price is specified. *Rankin v. Newman*, 114 Cal. 365, 46 Pac. 742 (1896), and whether the agreed price is too high or too low. *Kaufmann v. Kaufmann*, 222 Pa. 58, 70 Atl. 956 (1908); *Murphy v. Murphy*, 217 Mass. 233, 104 N.E. 466 (1914).

¹⁶ *Helms v. Duckworth*, 249 F. 2d 482 (D.C. Cir. 1957), involved the question of good faith as to bona fide negotiation of price. *Cerceo v. DeMarco*, 391 Pa. 157, 137 A. 2d 296 (Penn. 1958), deals with the lack of consideration. The buy out arrangements called for insurance which was never acquired. The court held that the buy out failed for lack of consideration.

Note must also be made of a line of cases decided in New York. In *Topkin, Loring & Schwartz*, 249 N.Y. 206, 163 N.E. 735, 66 A.L.R. 1179 (1928), *Schwartz* refused to sell his shares on the ground that since the corporation could purchase the shares only out of surplus, the agreement was not binding upon the corporation because there was no assurance that there would be surplus available when the corporation would be called upon to repurchase. The court agreed. The important point to note, however, was that the agreement did not provide any method for accumulating funds to pay for the shares. Life insurance was not used.

In *Greater New York Carpet House v. Herschmann*, 258 App. Div. 649, 17 N.Y.S. 2d 483 (1940), the agreement was funded with insurance purchased by the corporation. The court held the latter fact to be sufficient to differentiate this case from the *Schwartz* case. The defense of lack of surplus, if there were such a lack in spite of the insurance, could be asserted only on *Herschmann's* death, but the agreement itself was binding and valid. See also: *Ionic Shop, Inc. v. Rothfeld*, 64 N.Y.S. 2d 101 (1946); *Murphy v. Murphy, Inc.*, 166 N.Y.S. 2d 290 (1957).

need for a suitable endorsement on the stock certificates indicating that the shares were subject to the provisions of the agreement.¹⁷ Enforceability, in some cases, is by way of specific performance, if the business interest is unique in nature and damages are not readily ascertainable.

Right of Corporation to Redeem

A number of problems exist with respect to the right of a corporation to purchase its own shares. The majority rule¹⁸ is that a solvent corporation may lawfully purchase its own shares, in the absence of express contrary restrictions, provided it acts in good faith and without prejudice to the rights of creditors, and has a surplus with which to make the purchase. The statutes of many states now directly permit the repurchase of stock.¹⁹ Where prohibitions exist, they are intended for the protection of creditors and for the prevention of discrimination and favoritism among the stockholders.²⁰

Some states merely require that the shares be paid for only out of surplus.²¹ Some states permit the creation of surplus by a reduction of capital.²² Unless creditors would be adversely affected, a provision in the agreement providing for the creation of surplus by the reduction of capital would appear to be practical.

It should be noted that life insurance proceeds, if not subject to the transfer for value rule, are received free of income taxes and, accordingly, create surplus to the degree that the proceeds are not offset by existing deficits. Out of such surplus there can be a redemption of shares.

¹⁷ To insure enforceability, the stock certificates should be stamped or endorsed with a summary of restrictions on the transferability of that stock. If no Such statement is placed on the certificate, Sec. 15 of the Uniform Stock Act provides that there shall be no lien in favor of the corporation or restriction on the transfer.

¹⁸ See: 6A FLETCHER CYC. CORP. § 2845 (1950).

¹⁹ See: 2 R & R Advanced Underwriting Service, 15-31, for a breakdown, state by state, of the requirements with respect to this problem.

²⁰ For example, preemptive rights do not attach to treasury stock. 18 C.J.S. Corporations § 201(d) (1939), *Borg v. International Silver Co.*, 11 F. 2d 143 (2nd Cir. 1926). There is also the danger of an insolvent corporation purchasing shares of favored individuals before dissolution of the corporation. See also 19 C.J.S. Corporations § 950 (1940).

²¹ *E.g.*, Ark., Cal., Del., Fla., Ga., Kan., La., Md., Mich., Minn., N.H., N.J., N.C., N.D., Okla., N.Y., Ore., S.D., Tenn., Wis. In some states, such as New York, this rule is predicated upon court decisions rather than statute. *Cross v. Beguelin*, 252 N.Y. 262, 169 N.E. 378, *aff'd* 226 App. Div. 349, 235 N.Y.S. 336 (1929); *Richards v. Ernest Wiener Co.*, 207 N.Y. 59, 100 N.E. 593 (1912). The New York Penal Code does, however, provide that a director voting for the repurchase of corporate shares out of funds other than surplus shall be guilty of a misdemeanor. NEW YORK PENAL CODE, § 664, as amended by Laws of 1924, Chap. 221. In Illinois, a corporation may purchase its own stock provided the redemption will not reduce "the remaining assets of the corporation below an amount sufficient to pay all debts and known liabilities of the corporation as they mature. . . ." ILLINOIS BUSINESS CORPORATION ACT 1955, § 58. A few states require express statutory or charter provisions before redemption will be permitted. *Petre v. Bruce*, 157 Tenn. 131, 7 S.W. 2d 43 (1928); *Security Nat. Bank v. Crystal Ice & Fuel Co.*, 145 Kan. 899, 67 P. 2d 527 (1937).

²² *E.g.*, ILLINOIS BUSINESS CORPORATION ACT 1955, § 60.

Majority v. Minority

Occasionally, the question arises as to whether the majority stockholders may cause the corporation to enter into a stock retirement agreement with them over the objection of the minority. The problem is, basically, the right of the majority versus the minority. While corporate control vests in the majority, the minority do have certain well defined rights. They can challenge the action of the majority where such action may injure the corporation or the minority.²³ The majority may not act for its own benefit to the detriment of the corporation or the minority.²⁴

The minority has no right, however, to interfere with any action of the majority taken in good faith and not intended to be injurious.²⁵ Hence, it would seem that a stock retirement agreement between the corporation and some of its stockholders, if entered into on notice and in good faith, and with a fair valuation placed upon the shares, could not be successfully attacked by the minority, even though the latter voted against such an agreement at corporate meetings.²⁶

CORPORATE TAX PROBLEMS

Capital Gain Treatment

Those who use the stock redemption approach must be aware of many tax problems. Ordinarily, the redemption by a corporation of all of the shares of a stockholder is given capital gains treatment. It is regarded as a sale or exchange.²⁷ After death, the same treatment applies, but gain is measured by the difference between value for estate tax purposes and the amount realized on the sale.²⁸ Normally, however, if the sale is pursuant to a valid and adequate survivor purchase agreement, there will be no difference between the amount realized on the sale and the valuation for estate tax purposes. This is true even if there is a partial redemption under Section 303 (to which reference will be made later).

Ordinary Income — Attribution Rules

However, if Section 318 applies, a stock redemption may give rise

²³ *Weber v. Climax Molybdenum Co.*, 217 App. Div. 756, 127 Misc. 470, 216 N.Y.S. 481 (1926); *Allied Chemical & Dye Corp. v. Steel & Tube Co.*, 14 Del. Ch. 1, 120 Atl. 486 (1923).

²⁴ *Duffy v. Omaha Merchants' Express & Transfer Co.*, 127 Neb. 273, 255 N.W. 1 (1934); *Henderson v. Garner*, 200 Ala. 59, 75 So. 387 (1917).

²⁵ *Martin Orchard Co. v. Fruit Growers Canning Co.*, 203 Wis. 97, 233 N.W. 603 (1930); *Crowe v. Consolidated Lumber Co.*, 239 Mich. 300, 214 N.W. 126 (1927).

²⁶ A Corporation may repurchase stock from its employees and officers so long as the transaction is pursuant to a valid contract and the corporation is not insolvent. 6 FLETCHER CYC. CORP. § 2858 (1950).

²⁷ INT. REV. CODE OF 1954, § 302(a).

²⁸ Property passing from a decedent receives a stepped-up basis equal to its fair market value at the time of decedents' death. INT. REV. CODE OF 1954, § 1014(a). Since a decedent's property is valued according to its fair market value as of the date of death for estate tax purposes, INT. REV. CODE OF 1954, § 2031, that valuation becomes its basis for purposes of subsequent sale.

to ordinary income rather than a capital gain. Section 318 relates to the family attribution rules. It is applicable to a corporate situation where members of the same family—father, wife, children, grandchildren—own shares, whether or not there also are other non-family stockholders. That section generally also applies where the family members are associated in a partnership, as stockholders in another corporation, or as beneficiaries of a trust or estate.²⁹ The result is that the shares of all the family members may be attributed to the one seeking redemption, so as to make impossible the full redemption of his shares, unless certain difficult, and often impossible, tests are met.

Take the case of the Black & White Corporation, with 100 shares outstanding. Black owns 30 and the White family owns 70. John White, the father, owns 40 of these 70 shares. His two sons and his wife each own 10. Assume that White's 40 shares are worth \$100,000 and that there is a stock retirement agreement in force, pursuant to which the corporation is to purchase John White's shares from his his estate for \$100,000.

If White dies, and a purchase of his 40 shares were made pursuant to the agreement, and assuming that such redemption did not come under the limited shelter provided by Section 303, the payment by the corporation to White's estate would constitute a taxable dividend to it. This is because, under Section 318, the shares owned by Mrs. White and the two sons would be attributed to Mr. White, and the purchase of the 40 shares did not qualify as a complete redemption because other members of the family still owned 30 shares attributed to White, and because the redemption of 40 of the 70 White shares did not qualify as a disproportionate partial redemption—a complicated test set forth in the Code.³⁰

Under these circumstances, the estate would be required to pay an income tax on a \$100,000 dividend. If White's estate were substantial, it is possible that the income tax, the estate tax and the inheritance tax might even exceed \$100,000.

²⁹ INT. REV. CODE OF 1954, § 318. See Laikin, *Stock Redemption: 302 and 318*, N.Y.U. 14TH INST. ON FED. TAX 671 (1955). The related entity rules attribute ownership to the stockholder of his ratable portion of the shares owned by any partnership, trust, or estate of which he is a member or beneficiary; also, all of the shares of the trust of which he is considered the owner for income tax purposes, also the shares owned by a corporation with respect to which he owns, directly or by attribution, 50% of the value of its outstanding shares. Conversely, all of the shares of the stockholder are attributed to his children, spouse, parents, grandparents, and to a partnership, trust, estate, or corporation of which he is a member or beneficiary, but his shares will only be attributed to the corporation if he owns more than 50% of the stock thereby of value.

³⁰ There can be disproportionate partial redemption with respect to a shareholder if the percentage-ratio of his voting stock after redemption is at least 20% less than his percentage-ratio of voting stock prior to the redemption; and, his remaining voting shares constitute less than 50% of the outstanding voting shares after the redemption.

This type of danger is present with almost every stock retirement agreement where more than one member of the family is a stockholder. However, the attribution rules do not apply as between brothers, unless their parents are also stockholders, or the brothers are beneficiaries of the same trust or estate, or are stockholders in another corporation which holds shares in the one which is to make the redemption.

Some attention is now being given by Congressional Committees, and committees of the various professional groups, to ameliorate these difficulties. However, the changes recommended are limited in scope, so that the basic problems of Section 318 may still remain.³¹

Danger in Existing Stock Retirement Agreements

The foregoing problems are aggravated by the fact that in recent years there has been considerable estate planning. In connection therewith, many gifts of stock in closely held corporations have been made to children, to spouses and to trusts for them. This suggests that where a situation involves the attribution rules of Section 318, the safest approach to avoid dividend treatment, if a buy out is required, is to use the cross purchase.³²

On the other hand, an agreement could be drawn in the form of a binding option which would give the estate the option to cause the corporation to redeem all or part of its shares. Such an agreement would have the advantage of enabling the estate to determine whether or not it would be safe, taxwise, to enforce a redemption. Such an agreement might also provide that surviving stockholders shall personally acquire the shares to the extent that the corporation is unable to, or does not, make the purchase.³³

Existing stock retirement agreements which may be vulnerable under Section 318 also present the danger that the surviving stockholders may insist on carrying out the agreement by a sale to the corporation, regardless of the income tax consequences to the decedent's estate.

Section 303 Redemptions

Section 303 provides that at death a corporation may redeem such number of shares held by an estate which will provide the estate with an amount sufficient to cover the estate and inheritance taxes, and administrative costs, without causing the amount received to be taxed

³¹ For a discussion of expected changes see: 7 J. TAXATION 66 (Aug. 1958).

³² See Rev. Rul. 58-111, 1958 INT. REV. BULL. No. 12 at 9, providing that in the event of the redemption of stock of a corporation where § 318(a) is applied to determine the constructive ownership of stock for the purposes of § 302, the beneficiaries proportionate interests in the stock owned by an estate would be determined as of the date of redemption. This would allow one beneficiary to receive his share before redemption and prevent attribution between the beneficiary and the estate. It further suggests that the distribution from the estate to the various beneficiaries might be so timed that at the time of redemption the 302 and 318 rules will be voided.

³³ However, if the estate has the option the price fixed in the agreement may not necessarily be acceptable to the government as fixing the value for estate tax purposes.

as a dividend. The attribution rules of Section 318 do not apply to shares redeemed under Section 303.³⁴

Section 303 applies where the shares of the particular corporation held by the estate constitute 35% of the gross estate, or 50% of the taxable estate. Where the shares of more than one corporation are to be redeemed, the estate must own 75% of the outstanding stock of each corporation, in which case the 35% and 50% rules apply to the combination.³⁵

While Section 303 provides a degree of relief in given cases, it does not function automatically. Unless a proposed redemption is supported by an agreement, the corporation and the surviving stockholders may refuse to carry out the redemption. If a partial redemption does take place, it may convert a majority position to a minority one. If insurance is used to fund a redemption but there is no agreement with respect thereto, and if the parties fail to agree on value, the redemption may not take place, with the result that the insurance may actually have the effect of increasing the value of the shares for tax purposes.

PARTNERSHIP TAX PROBLEMS

Income Tax

Death does not itself terminate the income tax year of a partnership unless the agreement expressly so provides. However, the sale of a partnership interest will terminate the tax year with respect to the seller, and if the sale involves more than a 50% interest, it will terminate the tax year of the partnership for all of the partners.³⁶ Failure to recognize these rules may result in the bunching of income of an entire partnership year with that of a partial year, thus increasing the individual's applicable brackets. This might occur where one partner is on a calendar year basis, the partnership is on a fiscal year basis, and pursuant to agreement his interest is sold at death. The better practice, in proper situations, is to have the sale take place after death and have the income for the short fiscal period reportable by the estate. Perhaps some of this income could be paid out as a deductible widow's allowance, thus bringing about a lowering of brackets, and, if the income is substantial, it may also be advantageous to take some of the administration expenses as deductions.

If the purchase is between partners, capital gains treatment usually results.³⁷ If the entity approach (purchase by the partnerships) is used, there could be either capital gain or ordinary income treatment, de-

³⁴ INT. REV. CODE OF 1954, § 303 makes no reference to § 318 which only applies if such reference is made, § 318(a).

³⁵ INT. REV. CODE OF 1954, § 303 (b) (1) (B).

³⁶ INT. REV. CODE OF 1954, § 708(b).

³⁷ INT. REV. CODE OF 1954, § 741. However, there is a specific exception to capital gain treatment in that unrealized receivables and substantially appreciated inventory will be subject to ordinary gain. These terms are defined in the "collapsible partnership" section, INT. REV. CODE OF 1954, § 751.

pending upon whether there is a purchase and sale of the partnership interest as a whole, or whether the purchase is via a continuation of the sharing of partnership income.³⁸

If the buyers desire an income tax deduction, the buy out must be couched in terms of a continuation of income. In such event, the income will be taxable to the recipient as ordinary income and not as capital gains.³⁹ This approach is usually applicable where the entity purchases rather than the partners. Thus, if the surviving partners are in a high income tax bracket, it might be advantageous for them to use the income type rather than the capital transaction type of agreement. This will reduce their income taxes and they might be willing to pass on some of the savings to the decedent's estate or family.⁴⁰

Collapsible Partnership

Either approach may involve the new collapsible partnership rules which may negate capital gain treatment to the extent that the partnership interest contains unrealized accounts receivable or substantially appreciated inventories.⁴¹ In addition, with respect to partnerships operating on a cash basis, such as a professional partnership, the amount of the accounts receivable included in the partnership interest sold may be regarded as income with respect to a decedent, and be subject to ordinary income taxes to the estate.⁴²

³⁸ § 736(a) provides for ordinary income treatment to the seller if the purchase price is determined "... with regard to the income of the partnership ..." or if the purchase price constitutes a "... guaranteed payment described in section 707(c)" § 707(c) refers to guaranteed payments determined without regard to the income of the partnership made to a partner for services or the use of capital.

³⁹ INT. REV. CODE OF 1954, §§ 736(a) and 736(b).

⁴⁰ It should be noted that professional or service partnership agreements generally proceed under § 736(a).

⁴¹ If the income approach under § 736(a) is used, clearly all of the partnership assets, including unrealized receivables and substantially appreciated inventory will be subject to ordinary income treatment. If the capital transaction approach is used, unrealized receivables are specifically excluded from capital gain treatment by § 736(b) (2) (A). Once it has been determined that a payment for a partnership interest is a distribution under § 736(b), as distinguished from a distributive share or a guaranteed payment under § 736(a), then references must be made to § 731 which provides that a "distribution" is a "sale or exchange" and thus entitled to capital gain treatment. However, § 731(c) specifically excludes § 751 items (unrealized receivables and substantially appreciated inventory) from capital gain treatment.

⁴² If the income approach under § 736(a) is used, clearly all of the partnership assets, including unrealized receivables and substantially appreciated inventory will be subject to ordinary income treatment. If the capital transaction approach is used, unrealized receivables are specifically excluded from capital gain treatment by § 736(b) (2) (A). Once it has been determined that a payment for a partnership interest is a distribution under § 736(b), as distinguished from a distributive share or a guaranteed payment under § 736(a), then references must be made to § 731 which provides that a "distribution" is a "sale or exchange" and thus entitled to capital gain treatment. However, § 731(c) specifically excludes § 751 items (unrealized receivables and substantially appreciated inventory) from capital gain treatment.

⁴³ § 753 makes it clear that payments made under § 736(a) are income in respect to a decedent. Since § 736(b) (2) (A) places unrealized receivables under

Stepped-Up Basis

Where the cross purchase approach is used, the surviving partners will be entitled to a basis for the interest purchased equal to their cost. The assets in the hands of the partnership allocable to the interest purchased may also receive a stepped-up basis if the election under Section 754 is in effect.⁴³ If the partnership itself purchases and such election is in effect, the basis of the partnership property will likewise be adjusted in relation to the amount paid, pursuant to Section 734.

Thus, the partners may receive a stepped-up basis for such assets through the partnership. This applies whether accumulated partnership income is used for the purchase, the partners contribute additional cash, or insurance proceeds are received and used for such purpose. But, if insurance proceeds are used, the agreement should preclude the allocation of any part thereof to the deceased partner's interest.⁴⁴

Partnership survivor purchase agreements must also cover the issue of good will, both for the purpose of properly evaluating the worth of the partnership's interest, and with respect to tax consequences. Under the present Code,⁴⁵ if the selling price of the partnership interest exceeds the fair value thereof, the difference will be taxed as ordinary income unless the agreement specifically provides that such difference represents good will, in which event it will be treated as a capital asset. Thus, the agreement should indicate that good will is included or that no good will exists.

LIFE INSURANCE

Life insurance usually furnishes the most practical method of providing money with which to fund a survivor purchase agreement. The parties to such an agreement have an insurable interest in each

§ 736(a), there is little doubt but that unrealized receivables will, in all such partnership transactions, be considered as income in respect to a decedent and consequently be subject to ordinary income treatment. It should be noted that § 753 does not make mention of unrealized receivables and substantially appreciated inventory when the partnership interest is sold to the surviving partners (as distinguished from a sale to the partnership itself). However, since these items are specifically given ordinary income treatment under §§ 741 and 751, and since they do amount to assets in the hands of the deceased partner and as such must be valued in his estate, there is little doubt but that such items are also income in respect of a decedent.

⁴³ § 754 permits the partnership to file an election and obtain adjustments to the basis of property which it holds when there has been a distribution of partnership property under § 734 or when there has been a transfer of a partnership interest under § 743.

⁴⁴ § 704(b) automatically allocates part of the tax exempt income, such as insurance proceeds, to the deceased partner unless some other allocation is made, either in the partnership agreement or between the partners. Therefore, the agreement should provide that none of the insurance proceeds be allocated to the deceased partner and thus increase his partnership valuation. Of course, this can be overcome by an appropriate formula in the agreement for the valuation of the interest.

⁴⁵ INT. REV. CODE OF 1954, § 736(b) (2) (B).

other.⁴⁶ Premiums paid are not deductible for income tax purposes.⁴⁷ They are not deductible as ordinary and necessary business expenses.⁴⁸ However, the proceeds of policies paid by reason of death are not taxable as income,⁴⁹ unless the policies were transferred for value.⁵⁰

A transfer for value could take place in connection with a cross purchase agreement between stockholders where the survivors acquire the policies owned by the decedent on their own lives. In this respect the 1954 Code has changed the old transfer for value rule so that the income tax no longer attaches to the proceeds of policies which are transferred between members of a partnership, between a partnership and the members thereof and vice versa, or between a corporation and its stockholders. Unfortunately, the rule was not made broad enough to exempt transfers between stockholders.⁵¹

Premiums Generally Not Dividends

While the so-called "premium payment test" was eliminated from the law by the 1954 Code, the government is seeking to achieve an analogous result by taxing as income to the stockholders the premiums paid by the corporation for insurance on their lives. A series of recent cases, *Casale*,⁵² *Pruvier*,⁵³ and *Sanders*,⁵⁴ each presented a unique situ-

⁴⁶ *Fleming v. Fleming*, 194 Iowa 71, 184 N.W. 296 (1921); *Atkins v. Cotter*, 145 Ark. 326, 224 S.W. 71 (1920); *Connecticut Mutual Life Ins. Co. vs. Luchs*, 102 U.S. 498 (1883); *Mutual Life Ins. Co. v. Armstrong*, 117 U.S. 591 (1885). This is in accord with the general rule that an insurable interest exists if the purchaser of insurance derives some benefit from the life of the insured, or will suffer some loss or detriment at his death. *Warnock v. Davis*, 104 U.S. 775 (1882); *Mutual Aid Union vs. Stephens*, 97 Okla. 283, 223 Pac. 648 (1924). The members of a partnership or a closed corporation thus clearly would have an insurable interest in each other's lives. *Rohders v. Peoples Bank*, 113 Minn. 496, 130 N.W. 16 (1911); *Keckley v. Coshoccon Glass Co.*, 86 Ohio 213, 99 N.E. 299 (1912). The same reasoning would also apply to a corporation and its stockholders where continuity and proper management may depend upon preventing the sale or devolution of decedent's interest to outsiders.

⁴⁷ INT. REV. CODE OF 1954, § 264.

⁴⁸ *Nussbaum v. Comm.*, 19 B.T.A. 868 (1930).

⁴⁹ INT. REV. CODE OF 1954, § 101.

⁵⁰ INT. REV. CODE OF 1954, § 101(a) (2).

⁵¹ INT. REV. CODE OF 1954, § 101(a) (2) specifically states that if the transfer of life insurance is to the insured, to a partner of the insured, to a partnership in which the insured is a member, or to a corporation in which the insured is a shareholder or officer, such transfer, even though it be for a valuable consideration, will not cause the proceeds to be taxed as ordinary income. It should be noted that under this section a transfer between one shareholder and another shareholder, who is not the insured, will cause the proceeds to be subject to income tax.

⁵² *Casale v. Comm.*, 247 F. 2d 440 (2nd Cir. 1957), *rev'g* 26 T.C. 1020. A 98% shareholder entered into a personal retirement contract with his corporation calling for payment after he reached the age of 65. The corporation then took out retirement insurance which in turn was payable in the same manner as the contract of retirement. However, the contract did not refer to the insurance. The Court of Appeals held that the premiums were not income to the shareholder because the corporation was not a sham; it had a valid business purpose; and it derived benefit from the insurance. See: *Casale Reversed*, 7 J. TAXATION 258 (Nov. 1957); Laikin, *Alter Ego, Life Insurance and Taxes*, 7 C.L.U. JOURNAL 32 (Dec. 1952).

ation in which unconventional insurance arrangements were used. The trial court held, in each case, that the premiums constituted dividend income to the stockholders who were insured. But, in each case, the appellate court, looking to substance, as distinguished from form, considered the business purposes behind the arrangements, noted the advantages to the corporations, was cognizant of the fact that there were also advantages to the stockholders, but refused to weigh the relative advantages to each. Having found a business purpose and advantages to the corporations, the courts refused to disregard the corporate entity,⁵⁵ regarded the insurance as corporate assets, and held that the premiums were not taxable income to the stockholders.

These holdings have confirmed the traditional method of handling life insurance under corporate stock retirement agreements, to-wit: That the corporation should own the policy, be the beneficiary thereof, and pay the premiums. Had the parties in these three cases complied with these well established principles, the arrangements would probably never have been challenged by the Revenue Service.

⁵³*Prunier v. Comm.*, 248 F. 2d 818 (1st Cir. 1957), *rev'g* 28 T.C. 19. Two brothers who were the sole shareholders, each took out insurance on his own life and made the insurance payable to his own estate. The minutes of the corporation stated that the insurance was to buy out the stock of the first to die. The corporation then paid the premiums on the insurance. It was held that the premiums were not income to the two brothers. The court found that the corporation, by virtue of the notations in the minutes, was the equitable owner of the policies under state law. Once the court reached this point it merely reiterated the rules laid down in the *Casale* case. The court refused to weigh the benefit conferred on the shareholder as compared with the benefit conferred on the corporation. *Prunier Reversed*, 8 J. TAXATION 12 (Jan. 1958).

⁵⁴*Sanders v. Fox*, 253 F. 2d 860 (10th Cir. 1958), *rev'g* 149 F. Supp. 942. The corporation took out insurance on the lives of its four shareholders and paid the premiums thereon. The shareholders had entered into a contract with the corporation whereby they could designate the beneficiaries of the insurance. The Court of Appeals held that the premiums paid were not taxable as income to the shareholders, because the policies were corporate assets subject to creditors at all times. The court refused to weigh the benefits conferred on the shareholders as compared with the benefits conferred on the corporation. It merely stated that there was a benefit conferred on the corporation which was sufficient. *Sanders Reversed*, 8 J. TAXATION 322 (June 1958).

If it is found that the survivors are the owners of the policies, then the premiums paid by the corporation are taxable as dividends to the survivors. *Paramount-Richards Theatres, Inc. v. Comm.*, 153 F. 2d 602 (5th Cir. 1946).

Doran v. Comm., 246 F. 2d 934 (9th Cir. 1957), implies the same thing.

⁵⁵But see *Comm. v. Bonwit*, 87 F. 2d 764 (2nd Cir. 1937), where the chief stockholder caused the company to take out insurance on his life. The proceeds were payable to his children, and the right to change beneficiaries was not reserved. It was held that the premiums paid by the corporation amounted to taxable income to the chief stockholder. The danger of this case lies in the fact that although the insurance policy seems to be an asset of the corporation, which is available to general creditors, yet the court reached the result that the corporation had no ownership in the policy. It is true that other acts indicate that the parties treated the premiums as additional compensation. For example, the premiums were deducted as additional compensation by the corporation. The corporation had none of the incidents of ownership. It had no right to change beneficiaries, no right to make a loan against the policy, and no right to receive dividends.

Effect of Redemption on Surviving Stockholders

While the government's attack along this front appears to have been repulsed, it has launched another assault in a different area. It has contended that where the corporation redeems the shares of one stockholder, the remaining stockholders receive constructive dividends to the extent of the amount paid to the retiring stockholder. It has taken this approach in *Zipp*⁵⁶ and *Holsey*.⁵⁷ Although the government's position in the *Zipp* case has been affirmed, the *Holsey* case has been reversed.⁵⁸ In reversing the *Holsey* case, the court distinguished the *Zipp* case by classifying the *Zipp* case as a situation where the corporation discharged an obligation of the stockholder in redeeming the shares of another stockholder.⁵⁹ No such obligation on the part of the stockholder was found to exist in the *Holsey* case. The court rejected the government's contention that the redemption of one shareholder's stock constituted a taxable dividend to the remaining shareholders. The government is not applying for certiorari and therefore is presumably acquiescing in the result.

Furthermore, if the government's position were ultimately upheld, it would make meaningless much of Section 302 which undertakes to set forth rules under which there may be a redemption of stock on a capital gains basis. A conventionally prepared stock retirement agree-

⁵⁶ 28 T.C. 314, *aff'd* May 21, 1958 (6th Cir.).

⁵⁷ 28 T.C. 962, *reversed* Sept. 3, 1958 (3rd Cir.).

⁵⁸ In the *Zipp* case the father owned 48 of the 50 shares. The other two were owned by the sons. However, 46 of the 48 shares were in the names of his two sons, endorsed in blank, and not in the sons' possession. The father then gave up his interest in the 46 shares of stock and transferred his remaining two shares to the corporation in return for a large payment of cash made by the corporation. The court held that the payment by the corporation amounted to a constructive dividend to the two sons and taxed each son on one-half of the payment made. The court generally held that there was no business purpose in this redemption and that the only persons who benefited therefrom were the two sons.

In the *Holsey* case, *Holsey* transferred his option to purchase stock to the corporation. The corporation exercised the option, redeemed the other outstanding shares, and left *Holsey* as the sole shareholder. The trial court held that since *Holsey* and not the corporation was primarily benefited by the transaction, such redemption constituted a taxable dividend to *Holsey*. The appellate court first determined that the option did not constitute an obligation to purchase the retiring shareholder's stock, and there was, therefore, no obligation on *Holsey's* part which the corporation was discharging by redeeming such stock. The court then stated that although the redemption of one shareholder's stock may increase the value of another shareholder's stock, no income is realized to the surviving shareholder until an actual distribution is made. The position of the appellate court is in accord with reasoning found in *Zens v. Zuinliven*, 213 F. 2d 914 (6th Cir. 1954); *Tucker v. Comm.*, 226 F. 2d 177 (8th Cir. 1955), *reversing* *Tucker*, 23 T.C. 115; *Ray Edenfield*, 19 T.C. 13 (1952).

⁵⁹ If the surviving stockholders are obligated to buy out the interest of the deceased shareholder and the corporation makes such payment for them, the amount of the payment will be taxable as a dividend to the surviving shareholders. *Douglas v. Willcuts*, 296 U.S. 1 (1935); *Wall v. U.S.*, 164 F. 2d 462 (4th Cir. 1947); *Lowenthal, et al*, 169 F. 2d 694 (7th Cir. 1948); *Byers v. Comm.*, 199 F. 2d 273 (8th Cir. 1952).

ment should preclude any danger of a constructive dividend. In any event, the possibility of such danger is not present under a cross purchase agreement to which the corporation is not a party.⁶⁰

Settlement Options

Life insurance used for a survivor purchase agreement is sometimes programmed under the settlement options.⁶¹ The purpose is to give the decedent's widow the advantage which attaches to funds administered by the insurance company and paid out on an installment basis, as well as the additional advantage of some tax free interest. Prior to the 1954 Code, this approach was of greater significance. Now, the tax free interest is limited to \$1,000 per year, and only to payments received by the widow.⁶²

Where the use of options is desired, these guides should be followed: The arrangement should permit the survivor—the owner of the policy—to collect the proceeds if he finds it necessary or desirable to do so, thus enabling him to obtain the business interest by tendering the insurance cash therefor. The arrangement must be such that the estate of the decedent will not be confronted with additional tax burdens through possible loss of a part of the marital deduction. If a trustee is used, it must be protected against possible tax liabilities and claims of creditors, and must be given protection, through objective standards, for the exercise of its right of election as to whether the cash should be drawn down or the settlement options permitted to become effective.

It is believed that if appropriately handled, such settlement option arrangements are not adversely affected by *Casale*, *Prunier*, and *Sanders*, particularly since the courts have not sustained the government's contention.

Reference to Insurance in Agreement

While there is a divergence of opinion as to whether a survivor purchase agreement should refer to the insurance used to fund it, it is believed that if the agreement is well drawn and reflects a sound business purpose, there is no danger in referring to the insurance. Such reference relates to only one of the economic aspects of the ar-

⁶⁰ *Legallet v. Comm.*, 41 B.T.A. 294 (1940), should be noted. In that case, two partners each took out insurance payable to their respective wives and children. When partner B died his wife received the proceeds of the insurance, which amounted to \$20,000. Partner A then paid an additional \$30,000 to B's estate for his interest in the partnership. It had been previously agreed between A and B that the insurance would be applied toward the purchase of a deceased party's partnership interest. The partnership itself paid the premiums on the insurance. Later, when A wanted to sell the partnership, he claimed a basis for the interest purchased from B of \$50,000. The Board of Tax Appeals held that A was not entitled to step up his basis by the amount of the insurance which B had on his own life because that amount was not paid by A.

⁶¹ Laikin, *Settlement Options and Survivor Agreements*, 4 C.L.U. JOURNAL 199 (June 1950).

⁶² INT. REV. CODE OF 1954, § 101(d).

rangement required to make the agreement workable. In any event, if the doctrine of substance as distinguished from form is recognized, tax dangers will not depend merely on absence of reference if, in fact, insurance is used to fund the agreement. Nevertheless, an effective agreement may be drawn without such reference.

Problems Relating to Insurance Arrangements

The use of insurance for funding purposes has a bearing on whether the cross purchase or the entity approach should be used. Practical as well as tax considerations are involved.

Where there are several parties, a cross purchase agreement may become unwieldy. Each must procure insurance on the lives of others. Notwithstanding the amelioration of the transfer for value rule⁶³ relating to partners—but not to stockholders—the transfer of many policies on the lives of the surviving partners from the decedent's estate to each of them may become complex.⁶⁴

Financing insurance under a cross purchase arrangement presents another problem. It is usually easier for the entity to pay the premiums. For example, it is less burdensome to pay premiums out of surplus than for the individual stockholders to pay them out of salaries sharply depleted by taxes. While such premiums are not deductible,⁶⁵ they do constitute a legitimate application of surplus profits.⁶⁶ The accumulation of funds, through life insurance, to carry out a commitment under a stock retirement agreement designed to preserve the management and continuity of the business in the event of a death, should not be challengeable under Section 531 as an unreasonable accumulation of surplus.⁶⁷

Under a stock retirement agreement, the proportionate interests of the surviving stockholders are not affected by the redemption of the shares of the decedent. Under a cross purchase arrangement, the resulting relationship depends entirely upon the proportion each survivor has agreed to purchase. In the one case the result is automatic; in the other, it stems from negotiation.

⁶³ INT. REV. CODE OF 1954, § 101(a) (2).

⁶⁴ The mechanical problem of multiple policies under cross purchase arrangements could be resolved through the means of an agency or a trusteeship for the ownership of the policies on all of the partners, but such an arrangement would probably not solve any of the tax problems implicit therein. The transfer for value rule still applies to the transfer of the policies between stockholders, and the application of the rule could very likely not be avoided, notwithstanding the use of an agency or a trusteeship.

⁶⁵ INT. REV. CODE OF 1954, § 264.

⁶⁶ *Emeloid Co., Inc. v. Comm.*, 189 F.2d 230 (3rd Cir. 1951), *rev'g* 14 T.C. 1295 (1950).

⁶⁷ See Millet, *Key Man Life Insurance and Section 102*, 1 C.L.U. JOURNAL 462. The view that the use of life insurance to fund these agreements should not be challengeable under Sec. 531 is further supported by Diamond Life Bulletin Service. The most recent case, *Pelton Steel Casting Co. v. Commissioner*, —F (2d) — (7th Cir. 1958), 58-1 U.S.T.C. Para. 9179, *aff'g* 28 T.C. 153, has created some confusion in this area. It is treated at length below.

Often the interest of the individual which is to be purchased represents a large one, and those who are to buy represent a smaller interest. The lesser interest will have difficulty paying premiums with respect to the former. The problem is aggravated if the larger interest is held by a much older individual, with a substantially higher premium rate.

These difficulties sometimes preclude the use of the cross purchase arrangement although they can be ameliorated, to a degree, by the loan of monies from one party to the other to enable the latter to pay premiums, and by the use of some of the newer modes of financing insurance premiums. In any event, these difficulties are lessened where the entity approach is used. But, the entity approach gives rise to another type of inequity. Thus, the 75% stockholder or partner would in effect be contributing 75% of the premiums with respect to insurance on his own life, the proceeds of which are to be used to buy out his interest.

It has been suggested that this problem can be solved by including in the valuation formula the cash surrender value of all of the insurance policies, plus the proceeds from the decedent's policies.⁶⁸ If there were numerous individuals involved, this approach might be feasible. However, if there are only two or three individuals, the inclusion of the proceeds would increase the value of the business interest, making necessary the purchase of even more insurance for funding purposes.⁶⁹ Thus, inequities due to premium payments may result, even though the entity approach is used. But perhaps the risk of such inequities is justified by the greater ease of accomplishing the buy out through the entity.

Where No Insurance

Situations where some of the parties are uninsurable call for the payment of the purchase price in installments over a suitable period of time. Where the corporation redeems, it might be practical to issue preferred stock for the common stock acquired.⁷⁰ Sinking funds might be developed. Since the business purpose of such an agreement is beyond question, the moderate and reasonable development of a sinking fund should not be challenged as being an unreasonable accumulation of surplus.

The *Pelton* case,⁷¹ however, has a direct bearing on this conclu-

⁶⁸ See: Churchill, *Achieving Equity Under Entity Purchase Agreements*, INSURANCE RESEARCH & REVIEW SERVICE, INC. (1955).

⁶⁹ For statistics and examples bearing these facts out, see 94 TRUSTS AND ESTATES 284 (April 1955).

⁷⁰ Many types of corporate arrangements may be set up depending upon the facts of each individual case. These arrangements may vary from a simple stock transfer to a complete corporate reorganization. The main objective in most such arrangements would be to transfer voting control out of the hands of the decedent's estate to the survivors.

⁷¹ *Pelton Steel Casting Co. v. Comm.*, — F. 2d — (7th Cir. 1958), 58-1 U.S.T.C. Para. 9179, *aff'd* 28 T.C. 153.

sion. That case involved a lifetime buy out of two stockholders holding 80% of the shares. The facts showed a major shift in position from one wherein the corporation was regularly paying dividends, to another where it ceased paying dividends, with the obvious purpose of accumulating cash so that these controlling stockholders could liquidate their holdings on a capital gains basis. There was difficulty in finding a valid business purpose behind the bail-out of these principal stockholders. Accordingly, while the *Pelton* case may seem to challenge the conclusion stated, it is believed that it will not be controlling or have significant influence in cases wherein sinking funds are gradually built up to cover a buy out at death.

In a cross purchase situation where life insurance is not available, the surviving business associates must obligate themselves personally to pay for the interests of the decedent. Such obligations may complicate their personal estate programs and threaten the security of their families, particularly if a succession of deaths takes place. In some situations, it may be better to liquidate the business than to assume the personal obligation of paying for decedent's interest.

VALUATION

There is no method of valuation equally applicable to all businesses. Each has its own special problems and unique characteristics. Therefore, only basic and general considerations can be reviewed here.⁷²

Book Value

Resort to book value is undoubtedly the simplest method of valuing a business interest. Yet book value can be inaccurate, unfair, and economically meaningless. Book value does not reflect the appreciation or depreciation of assets, the worth of hidden assets, of intangibles, of earning power and of good will. It may, however, frequently be used as a point of departure in the development of a more accurate valuation.

Where book value is used, it should be determined as of a date previous to death, either as of the close of the fiscal year or of the month preceding death. This tends to eliminate suspicion as to adjustments of books after death in order to minimize value. If a date previous to death is used, fairness might dictate, depending on the kind of business, that there be an adjustment for profits, losses or drawings up to the time of death. Book value should be determined by an outside accountant and the agreement should expressly provide that his findings are to be conclusive and binding upon the parties.⁷³

⁷² For a general discussion of valuation problems see: Forster & Willis, *How to Draft a Partnership Buy and Sell Agreement*, 56 So. CALIF. TAX INST. 59; Rev. Rul. 54-77, 1954-1 CUM. BULL. 187; See also Rockerfeller, *Valuation of Closely Held Stocks for Estate and Gift Tax Purposes*, 36 TAXES 259 (April 1958), where such questions as when the market is not representative of the true values, and questions of the blockage problem, are discussed.

⁷³ The difficulties and dangers involved in adjusting as of the date of death

Good Will

If the business is one to which good will attaches, book value is an inadequate standard of valuation. On the other hand, the business may be one to which good will does not attach. Good will might exist only during the lifetime of the individual whose interest is purchased. This is particularly true of a professional practice where good will is so personal as to cease at death.⁷⁴ In any event, if the facts so require, the agreement should expressly indicate that the parties regard the business as being one which has no good will. Disputes and litigation between the parties⁷⁵ and with the tax authorities⁷⁶ may result if if this is overlooked.

The value of good will is basically dependent upon the earnings and prospects of a business. Its value represents a capitalization of earning power. This theory is applied by the Internal Revenue Service.⁷⁷ Under it, the amount of earnings attributable to good will is computed by (1) ascertaining the average annual net earnings of the business; (2) ascertaining the value of tangible assets; (3) subtracting from the total net earnings the earnings attributable to tangible property, and (4) capitalizing the balance.⁷⁸

For some businesses, a simple method of valuing good will might be used. The parties might agree that the good will is worth two (or

the book value determined as of a date previous thereto, can largely be avoided by the following technique: The balance sheet of the previous date is used as a starting point. Certain items are accepted at the figures that appear thereon. Others are adjusted as of the date of death. Thus cash and cash items are taken at their face value *as of the date of death*. Securities held at death are taken at their *then* market value. Accounts receivable, if reserves are inadequate, may be taken at 90% (e.g.) of the amounts thereof *at death*. Fixed assets, furniture and equipment could be valued at their replacement value *at death* as determined by appraisers. Real estate could likewise be valued *at death* by appraisal. The value of the inventory *at death* would be determined by *adding* to the book value of the inventory appearing on the *previous* balance sheet of the purchases from the date thereof to the date of death and *subtracting* therefrom the sales as reduced by the average mark-up for the same period. All other items on the balance sheet will be accepted at the figures that appear thereon.

⁷⁴ Cf. *Hoping v. Comm.*, P-H Tax Ct. Mem. 575 (1947); *O-Rear v. Comm.*, 80 F. 2d 472 (6th Cir. 1935).

⁷⁵ *Lanske v. Lanske*, 95 Pa. Super. 590 (1928); *Kaufman v. Kaufman*, 222 Pa. 58, 70 Atl. 596, *aff'd* 239 Pa. 42, 86 Atl. 634 (1913).

⁷⁶ See Rev. Rul. 157, 1953-2 CUM. BULL. 255; *Estate of Trammell*, 18 T.C. 662 (1952), holding that if there is no provision in the agreement for evaluating the good will, and no mention of it, the Commissioner is free to place a value thereon for estate tax purposes.

⁷⁷ See A.R.M. 34, 2 CUM. BULL. 31 (1920). For general discussion of problems relating to valuing good will, see 24 TAXES 1158 (1946); 25 TAXES 876 (1947); MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 59.35-59.44 (1958).

⁷⁸ In applying this formula, a number of difficulties arise. Among them are the determination of the proper rate of return to be derived from the tangibles, the number of years over which the earnings are to be averaged, whether the earnings shall be before or after taxes, whether certain years shall be excluded because they are abnormal, and the rate by which the earnings attributable to good will shall be capitalized. The determination of the proper rate of capitalization requires the exercise of sound business judgment. It has also been the subject of much tax litigation.

any number) times the average annual earnings over a given number of years. This method avoids the necessity of allocating earnings between tangibles and intangibles. It proves satisfactory and fair in many situations, particularly where good will and other intangibles are more important to the business than fixed assets.⁷⁹

Subjective Approach

The approach to placing a value on a business may be either objective or subjective. The subjective motivation—the desire to protect the decedent's family rather than the business—frequently outweighs the objective. To meet this situation, the agreement might provide that the parties shall agree, in writing, at regular intervals, as to the value to be used if a death takes place before the next valuation date.⁸⁰

The weakness of this method, however, is that the parties may neglect to re-evaluate periodically as required. Moreover, it may be awkward to discuss a re-evaluation, particularly if the revision is to be downward, while one of the parties to the agreement is seriously ill. Hence, in practice, it is better to provide for an automatic formula type of valuation.

Outside Offer

To guard against the possibility that the value arrived at pursuant to the agreement may prove unfair because of unforeseen circumstances, provision may be made permitting the decedent's estate to seek an outside offer for the purchase of the entire business. If the outside offer is greater than the value determined under the agreement, the survivors must elect either to pay for the decedent's interest on the basis of such outside offer, or to sell the entire business to the offeror. This arrangement is essentially fair. It protects the estate of the decedent and, at the same time, it permits the survivors to retain the business by paying a higher price. If the outside offer represents an amount greater than the survivors think wise to pay, they, too, can sell and receive the benefits of the high selling price.⁸¹

⁷⁹ In some cases it may be possible to value the entire business interest, instead of the good will alone, by the capitalization of earnings method. This method is particularly applicable to a service business and to one wherein tangible assets are not of paramount importance.

⁸⁰ It may then provide that the value set forth in the last valuation agreement prior to death shall determine the amount to be paid. The valuation thus determined will not differentiate between tangible and intangible assets. Such items as hidden assets, the depreciation or appreciation of values and all other factors affecting value may be reflected in the lump sum figure without identification. Book value will serve no more than as a guide to the value of some of the factors. Audits and inventory taking are avoided. If under the circumstances of a particular case, it is desirable to determine book value and good will separately, the simple method suggested above can be used with respect to good will alone. The frequency of the periodic valuations must depend upon the nature of the business. In one that fluctuates rapidly, monthly or quarterly valuations may be necessary. In others, semi-annual or annual valuations may be adequate.

⁸¹ Agreements sometimes provide that there shall be paid for the business interest, the amount at which it is valued for inheritance tax purposes. The

Appraisal

Appraisal is sometimes thought of as a method of valuation. But most businessmen prefer to avoid the uncertainties with respect to the amount of their obligations under a future appraisal.

Estate Tax Valuation

The problem of valuation is a frequent subject of tax litigation. The Internal Revenue Code provides for a determination of the value of all items in a decedent's estate as of the date of death, or one year after death.⁸² The regulations⁸³ provide that the value shall be the fair market value which it defines as "... the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price" The regulations make specific reference to good will and the need for evaluation of good will.⁸⁴

Clearly, it is easier to fix values during lifetime through the means of an agreement than to meet the requirements of the regulations. Moreover, a careful reading of the regulations suggests that Revenue Agents are encouraged to accept values fixed in an agreement for the sale of the decedent's estate. This is in accord with the long established practice of accepting, for estate tax purposes, values fixed by survivor purchase agreements.⁸⁵ Even if the value fixed by the agreement is not binding for estate tax purposes, it will, nevertheless, be taken into consideration in arriving at the true value.⁸⁶

method defeats one of the indirect benefits to be derived from the agreement, namely, the fixing of value for tax purposes. The tail would be wagging the dog. Moreover, since disputes with the tax authorities with respect to valuation may keep the matter open for a long time, the purchase and sale of the business interest after death would be delayed.

⁸² INT. REV. CODE OF 1954, §§ 2031 and 2032.

⁸³ TREAS. REG. § 20. 2031-1(b).

⁸⁴ TREAS. REG. § 20. 2031-3, which refers to partnerships and proprietorships, states in part that "Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners." TREAS. REG. § 20. 2031-2 deals with the values of stocks and bonds.

⁸⁵ RABKIN AND JOHNSON, 2 FEDERAL INCOME GIFT AND ESTATE TAXATION § 52.11 (1954), summarizes the law as follows (page 5291): "Where stock is subject at the time of death to an agreement of sale, or is subject to another's option to purchase at a specific price, the fair market value is limited to such price. . . . It is, of course, obvious that the stockholders in a closely held corporation may employ this method to prevent an excessive valuation of each stockholder's interest. It has been held that the tax avoidance of the contract does not affect its validity. . . ."

⁸⁶ Spitzer v. Comm., 153 F. 2d 967 (8th Cir. 1946). This case involves the valuation of stock for gift tax purposes. The court considered the effect of an agreement for the purchase and sale of a deceased's interest at death. While the court said that the agreement was not binding for gift tax purposes, it

Fixing Value by Agreement

In order that the value fixed by agreement be accepted, certain conditions must be met: The agreement must be based on consideration and not be a substitution for testamentary disposition.⁸⁷ It must be binding and not merely in the form of mutual options.⁸⁸ It must restrict the sale of the business interest during lifetime at a price higher than that fixed in the agreement. If the foregoing tests are met, the fact that the value fixed by the agreement is less than the fair market value at the time of death is immaterial.⁸⁹

indicated that it would consider the value fixed in the agreement as being one of the factors in the determination of value for gift tax purposes.

⁸⁷ *Murphy v. Murphy*, 217 Mass. 233, 104 N.E. 466 (1914); *In re Fieux's Estate*, 241 N.Y. 277, 149 N.E. 857 (1925); *McKinnon v. McKinnon*, 56 Fed. 409 (C.C.A. Mo. 1893).

⁸⁸ *Armstrong Estate v. Comm.*, 146 F. 2d 457 (7th Cir. 1944); *Cowles v. State of Wash.*, 219 P. 2d 964 (Wash. 1950); *Helen S. Delone*, 6 T.C. 1188 (1946), *acq.* 1946-2 CUM. BULL. 2; *Estate of Mathews v. Comm.*, 3 T.C. 525 (1944). The purchaser must have an enforceable irrevocable option for the valuation to be accepted for estate tax purposes.

⁸⁹ *In Wilson v. Bowers*, 57 F. 2d 682 (2nd Cir. 1932), three stockholders entered into a buy and sell agreement whereby the selling price of their stock was one-fourth the market value. The court found an enforceable option. In *Lomb v. Sugden*, 82 F. 2d 166 (2nd Cir. 1936), it was held that the agreed price of approximately \$70 a share prevailed for estate tax purposes when the fair market value was \$100 a share. In *Helvering v. Savage*, 297 U.S. 106 (1936), an income tax case, the cost basis of stock was not its fair market value but the lower price at which the issuing corporation had an option under a binding contract to repurchase the stock. In *Comm. v. Bense*, 100 F. 2d 639 (3rd Cir. 1938), where the son had an option to purchase his father's stock, the court upheld the option price even though it only amounted to approximately one-tenth of the fair market price. In *Estate of Mitchell v. Comm.*, 37 B.T.A. 1 (1938), no transfer of stock was permitted without a prior offer to the other party to the agreement at a price determinable under the instrument. Thus, the value controlled for estate tax purposes. In *Estate of Childs v. Comm.*, 147 F. 2d 368 (3rd Cir. 1945), the court accepted the option price of \$10 instead of the actual value of \$100 for estate tax purposes because of restrictive provisions in the agreement.

It should be noted, however, that an option to purchase need not be of indefinite duration after a death. Thus B may be given the option to purchase A's interest at a fixed price for 90 days after A's death. *Broderick v. Gore, Executor*, 244 F. 2d 892 (10th Cir. 1955). Since the ceiling price at A's death was the agreed amount, that amount will govern for estate tax purposes. Furthermore, such options may exist between family members and still retain their binding effect. *May v. McGowan*, 194 F. 2d 396 (2nd Cir. 1952).

If A has the option to sell his business interest to B at a fixed price at any time during his life, or if A's estate is given such option right, A's business interest will be included in his estate at the fair market value at A's death. The reason for this is clear, since A or his estate may sell to a third party at the fair market value. However, even if A does not have the right to sell to a third party, his interest will be included in his estate at its fair market value for the reason that A or his estate may never sell such interest. *Louise S. Schultz*, 14 B.T.A. 419 (1928), *Michigan Trust Co. et al.*, 27 B.T.A. 556 (1933). Thus it is important to realize which party has the option. If the purchaser has the exclusive option to buy at a fixed price, that price is the value of the interest and will govern for estate tax purposes. See *Rev. Rul. 54-76, 1954-1 CUM. BULL. 194*. If the seller has the option to sell at a fixed price, his interest will be included in the seller's estate at its fair market value.

The new estate tax regulations,⁹⁰ in speaking of valuation, provide that ". . . little weight will be accorded a price contained in an option or contract, under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime . . ." They further provide that even if there were a restriction on transfer during the lifetime of the decedent, the agreed value will not control for estate tax purposes unless ". . . the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth . . ." Thus, the parties to a survivor purchase agreement, especially if related, must undertake the burden of establishing that the agreement was negotiated in good faith, represents a real business transaction, and was not a substitution for a testamentary disposition. When such a burden is met, the value fixed by an intra-family agreement will be accepted.⁹¹

Alternate Valuation Date

Under Section 2032 of the Code the value of the business interest may be "pegged" for estate tax purposes. This section permits the estate of a decedent to be valued as of a date one year after death. If any asset is sold within the year, it must be valued at the moment for which it was sold. Hence, if a business interest is actually sold during the year after death, in a bona fide transaction, the selling price will "peg" the value for estate tax purposes—if the anniversary valuation date is used. If the date of death is used, a subsequent bona fide sale will very likely establish value.

Life Insurance in Valuation

Life insurance proceeds must be reckoned with in the scheme of valuation, particularly if the decedent's interest is purchased by the partnership or corporation. Specifically, the problem is whether the proceeds will be included as an asset of the business for the purpose of determining value. While the proposed estate tax regulations⁹² contained language to the effect that under certain circumstances the proceeds would be considered not only for valuation purposes but for the purpose of determining whether the agreement was bona fide, the final regulations⁹³ eliminated such provisions. From this, and from

⁹⁰ TREAS. REG. § 20.2031-2 (h).

⁹¹ Proposed Treas. Reg. § 20.2031-2 (h), established a presumption of consideration when the parties to a survivor purchase agreement were strangers. This presumption has been eliminated from the final regulations.

⁹² Proposed Treas. Reg. § 20.2042-1(c)(6) read in part: "However, if the insurance is owned by or payable to the partnership or corporation, or a trust created by it or for its benefit, the proceeds of insurance are considered as an asset of the partnership or corporation for the purposes of, first, determining whether the agreements were supported by full and adequate consideration in money or money's worth, and, second, determining the value of the deceased's interest or share if the agreement is not considered to have been entered into in good faith and at arm's length."

⁹³ TREAS. REG. § 20.2042-1.

the basic case law, the conclusion may be drawn that if the agreement is valid and binding, and fixes a price, the insurance proceeds will be disregarded.

However, if a valid and binding agreement is not in existence, it is fair to assume that now, as in the past,⁹⁴ an attempt will be made to include the proceeds as assets for valuation purposes. Even under such circumstances, there is the possibility of contending that the loss to the business of the individual insured should be offset against the proceeds received by virtue of his death.⁹⁵ In any event, valuation should be covered by agreement, wherever life insurance is used, whether a complete redemption is involved, or a partial purchase under Section 303.

State Rules Differ

The foregoing discussion has related to valuation for federal estate tax purposes. Many states⁹⁶ however, do not follow these rules. In general, they hold that the fair market value is to be taxed regardless of the existence of a bona fide binding agreement fixing a different value for buy out purposes.

CONCLUSION

The survivor purchase agreement is an effective instrument for pre-probate business planning. Whether the equity or cross purchase approach is used depends on the facts and tax aspects of each case. Wherever possible, life insurance should be used for funding purposes. The agreement will, obviously, be only as sound as the ability of the purchaser to make the required payments. The services of a corporate trustee usually strengthens the arrangement. Tax problems will be minimized if the instrument follows well established and recognized patterns.

⁹⁴ Estate of W. A. Blair, 4 B.T.A. 959 (1926); A. S. Kennedy, et al., Exrs., 4 B.T.A. 330 (1926).

⁹⁵ Estate of S. A. Scherer, B.T.A. Memo. Op. Dec. 11, 371-A, 42 B.T.A. 1480 (1940). One case has held that the proceeds of the insurance policy received upon the death of an officer should be decreased by the loss to the company resulting from the officer's death in valuing its stock. *Newell v. Comm.*, 66 F. 2d 103 (7th Cir. 1933).

⁹⁶ See: 1 FED. EST. & GIFT TAX REP. Paragraph 1202.08 (1958).